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"Expanding Equity Investment in Small Business"

Testimony of:
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Introduction

Chairman Altmire, Ranking Member Fallin, and members of the Committee, my name is Sherrill Neff and I am a partner at Quaker BioVentures, a venture capital firm based in Philadelphia, Pennsylvania. I am also a member of the National Venture Capital Association based in Arlington, Virginia. My views today represent 460 member firms which together currently have approximately 90 percent of all the venture capital under management in the United States.

Quaker BioVentures is a venture capital firm investing in life science companies with outstanding growth potential. The firm leads investments across the spectrum of the life sciences industry, including biopharmaceuticals, medical devices, human diagnostics, specialty pharmaceuticals, and healthcare services. We invest in companies at all stages of development, from raw start-ups to much later stage companies, and prefer to lead or co-lead investments, taking an active role on the Board of Directors at those entities in which we invest. We have investments in 31 different life sciences companies, all of which are headquartered on the East Coast of the United States, primarily in the Mid-Atlantic and Southeastern regions. Founded in 2003, the firm manages over $700 million in committed capital.

I would like to thank the Committee for the opportunity to share with you today an overview of the venture capital industry and the broad issues we are facing in the current economic climate. We believe that amidst the challenges our country is facing, there is tremendous opportunity for the private sector and government to work together, not only towards recovery but beyond -- towards a future in which our country is once again thriving economically, technologically and socially.

Venture Capital Investment Overview

To begin, I would like to explain briefly how the venture capital industry creates and grows small businesses. Typically, venture capital firms raise money from institutional investors with a long term focus such as pension funds, endowments and foundations. Our commitment is to invest those funds in promising young start up companies. Once a venture fund is raised, we look for the best and brightest entrepreneurs in which to invest, usually within a specific industry sector in which we have an operating expertise. And venture capitalists typically look for companies that are innovating in a significant way. For this reason, we are readily associated with information technology, life sciences, and most recently the clean technology industries. We often find these innovators in university and government labs, through others who are already in our network, or we work with entrepreneurs who we have successfully funded in the past.

In order for an investment to be considered for venture capital, the entrepreneur typically has a product or service that has gone through the discovery or prototyping process. The product is ready to be clinically tested, proceed through the lengthy regulatory process toward approval, and eventually commercialized. We stay invested in these companies – both financially and through the sweat equity we provide – from 7-10 years, often longer and rarely less. All of the venture funding is directed towards growing the company – both in employee hiring and in research and development expenditures. We do not engage in financial re-engineering nor do we typically utilize debt. The ultimate goal is to build the business until it can go public or become acquired, generating a return for our institutional investors. In most cases, venture capital is the only source of funding for these companies as the dollars required are too great for angels, friends or family, and the risks are too high for traditional bank financing.

In 2008, the venture capital industry invested more than $28 billion into over 3800 companies in the United States. This level of investment has been remarkably consistent over a number of years, averaging $26.3 billion into 3500 companies each year for the past five years. The industry is not interested in seeing these numbers grow substantially as we have learned from the technology bubble burst of 2000 that our asset class is not infinitely scalable. Yet we would very

much like to sustain existing investment levels and that promise has been significantly threatened in the wake of the current economic crisis.

No asset class is immune to this recession and the venture capital and start-up communities are no exception. We believe that our industry will contract as a result of the economic crisis but how much remains a question. Since venture capital is a critical driver of job creation and economic growth and has differentiated the US economy from all others for decades, this is an important question for Congress to be asking.

Venture-Backed Companies Drive U.S. Economic Growth

The venture capital industry is a relatively small asset class compared to other areas of private equity. In 2008, venture capitalists in the aggregate managed approximately $197 billion in assets or just 0.02 percent of the US GDP. Thomson Reuters estimates that there were fewer than 900 venture firms in the United States employing approximately 7,500 professionals last year**.** Yet despite our small size, our industry has created exponential economic value through the tens of thousands of companies in which we have invested.

According to the econometrics firm Global Insight, venture-backed companies currently account for more than 10.4 million jobs and $2.3 trillion in US revenues, representing 9 percent of US private sector employment and 18 percent of US GDP. Companies that were once small venture-backed businesses include: Google, Genentech, Intel, Cisco, Starbucks, Microsoft and FedEx. The venture industry has been recognized for its contribution to the creation of entire industries including the Internet, software, semiconductor, and biotechnology sectors, all which began with the funding of several hundred start-ups which grew in scale and now employ millions of Americans. And today our industry is actively creating yet another sector – the clean technology sector – which is our fastest growing area of investment and comprises companies operating in renewable energy, conservation, power management and sustainability.

Innovation is the cornerstone of all of our investments. As my area of expertise is life sciences, I would like to take a moment to share some of the groundbreaking areas that the venture industry is funding. We estimate that 1 out of every 3 Americans is positively impacted by a venture-

backed medical innovation. The industry invested nearly $8 billion last year, almost 30 percent of total venture capital investment, in more than 850 biotechnology and medical device companies.

At Quaker BioVentures, we have investments in amazingly innovative companies such as: (1) **Biolex**, which is producing protein drugs from a prolific aquatic plant organism known as duckweed, and has a late stage product for Hepatitis C infections; (2) **Amicus**, which is developing novel treatments for genetic diseases like Parkinson's Disease; (3) **Tengion**, which regenerates entire human organs from a patient's own cells;(4) **Neuronetics**, which has recently launched sales of an FDA-approved medical device for treatment-resistant major depression disorder; (5) **Optherion**, which is developing a novel drug therapy for the early, or "dry" form of age-related macular degeneration, a horrible and prevalent disease of the eye; (6) **Precision Therapeutics**, a molecular diagnostics company with highly specialized testing to support oncologists in their selection of the drugs most likely to have a beneficial effect in the treatment of gynecological and other cancers, and (7) **Regado Bioscience,** which is developing novel, controllable anticoagulation systems that we believe will be much safer and predictable than other methods of anticoagulation. Not only are these companies innovating; they are also employing. The Quaker portfolio alone represents several thousand jobs in the regions in which we invest. The same holds true for every venture capital firm around the country.

As active investors, venture capitalists are very proud of the work that we do and value that we create. But we do not profess to be able to do this alone. We rely heavily on the support of policy makers and regulators to foster an environment that encourages measured risk taking and capital formation. Our industry remains fragile, particularly in the wake of the recession and uncertainty of the capital markets. Yet we believe that most of these challenges can be mitigated with sound public policies and regulation.

Unlike many other areas within the financial services sector, the venture capital community is <u>not</u> in need of rescue and, in fact, has money to invest in emerging growth companies. We remain committed to finding and nurturing the most promising entrepreneurs in the United States and put forth that venture-backed companies continue to innovate and create the very jobs that

will drive economic recovery. But our industry is not without challenges, and today I would like to discuss ways in which policy makers can support our efforts to build great, innovative American companies.

Venture Industry and Government Together

The venture capital industry believes that what is good for entrepreneurs is good for venture capitalists, and ultimately for the economy. For that reason, we focus our advocacy efforts on advancing policies that help our portfolio companies thrive throughout their life cycle. We have historically found the federal government to be a supportive partner in bringing the best ideas out of the labs and garages and transforming them into vibrant companies that employ Americans and develop valued products and services globally. From nurturing the innovation pipeline to supporting the deployment of capital, policy makers and regulators have an important role to play alongside the work that venture capitalists do in bringing such companies to life. I would like to spend some time discussing those roles.

Supporting Long Term Investment

Historically, no other asset class is as committed to the high risk, long-term investing as venture capital is, and for good reason. Venture investing is not for the faint of heart. We don't just write a check and walk away. Once invested, a venture capitalist works hand-in-hand with company management to address market challenges and grow a business over many years. Approximately one third of our companies fail, and we must rely on the successes to balance our returns. But as I have mentioned, those successes have proven to be extremely valuable for our country's economy and, I would say, essential for the future of economic growth.

Our system has worked for decades in large part because the capital gains tax structure has motivated venture capitalists to make these longer term, high risk commitments. The result has been the creation of assets – new companies and jobs – that did not exist before. Encouraging this investing behavior is exactly what Congress intended when it enacted capital gains tax legislation years ago. It is critical that venture capitalists continue to be rewarded in a manner

commensurate with the huge risks we take. Otherwise our risk/reward equilibrium will be thrown off, and even highly promising companies will not get funded because we can not justify the risk.

The NVCA supports the existing tax structure as it applies to venture capital investment, which includes capital gains tax treatment for the carried interest portion of our investment return. This tax policy is proven to motivate investors for the long term and it supports investment in seed and early stage companies. As you may know, carried interest is only earned by venture capitalists after many years in the life of the fund, and only after a fund has returned all of the capital committed by its institutional investors. It is never guaranteed and rewards only those venture investors who have successfully built new companies.

The Administration's budget now has a provision to change the carried interest tax rate to ordinary income, effectively doubling or tripling the taxes of the very people most responsible for new company creation, job creation, and economic growth. At a time when our country needs to create jobs and rebuild industries, such a change is counterintuitive to economic growth. Tax policy is put in place to affect certain behaviors. We ask that the Congress look carefully at each industry impacted by a change to the carried interest tax rate and enact policies that are fair but continue to promote long term investment, not deter it.

Despite our concern over the President's carried interest tax proposal, we do believe that the Administration understands the importance of investment in small business. This understanding was evidenced in the President's inclusion of a zero capital gains tax rate for investment in small businesses in his budget proposal. While this provision was not detailed, we hope that Congress will consider the spirit in which it was included and perhaps apply this concept in its own budget to offer incentives for new investment in long term growth.

Nurturing the Discovery Pipeline.

The business of commercialization, that is, bringing innovations out of the labs and into the market, is indeed a long term process. Venture capitalists enter the life cycle very early, often

after the initial discovery process has been completed. We do not fund basic research but rather search for concepts that have been vetted through the basic research process and show promise for the broader public marketplace. We most often find these opportunities in university and government labs, where scientists have successfully accessed Federal funding to advance their work.

For example, my firm, Quaker Bioventures, recently helped to form Optherion, a Connecticut-based company, which as I mentioned earlier is developing novel therapies for "dry" AMD, a disease of the eye. This company was created from technology funded by the NIH at the University of Iowa, Yale University, the University of Pittsburgh Medical Center and Rockefeller University. We put these novel technologies together with an experienced management team, and helped the company to raise over $30 million in its initial round of funding. The company's drugs will begin human testing next year. Another recent startup we helped form is Maryland-based Arginetix. With the seed capital we provided, the company licensed NIH-funded technology from both the University of Pennsylvania and Johns Hopkins University. Arginetix is developing novel therapies for pulmonary arterial hypertension (PAH).

It is critical that the federal government continue to fund basic research, not just in life sciences but in other industry sectors such as energy and information technology as well. We were heartened to see the recently passed stimulus bill include a sizable allocation for basic research. It is critical that such funding continues if we want our innovation pipeline to remain strong. The venture industry is eager to leverage the most exciting scientific breakthroughs once the government has funded their discovery.

Yet, one of the areas that have been especially problematic in the area of basic research funding has been the definition of small business, particularly as it relates to eligibility for Small Business Innovative Research (SBIR) grants. Recent interpretations of the program have excluded certain companies from applying for these important grants if they have previously received venture capital. There is a misconception that venture-backed companies are not small businesses because of they have venture capital investors. However, I assert that nothing could be further from the truth. Venture-backed companies that apply for SBIR grants are the epitome

of small businesses, since they are often without any revenues and with employee counts in the single digits. They are just as fragile as their non-ventured counterparts and equally, if not more, worthy of consideration for grant money. Many of these companies would seek federal funding for discovery projects that their venture capital investors do not fund but may some day be appropriate for commercialization.

The venture capital community has been advocating for changes to the SBIR program to allow venture-backed companies to compete unequivocally for grants. This change in definition would expand and enhance the pool of applicants to include scientists and entrepreneurs who have already been vetted by the venture industry, certainly not a guarantee of success, but definitely a positive affirmation for the long-term promise of the businesses in question. The SBIR program is the perfect opportunity for the government and venture capital industry to work together on discovery projects that have significant potential to emerge from the lab, reach the marketplace and improve the lives of Americans. Yet today, this can not happen as companies must choose between venture funding to grow their business and government funding to sustain their innovation pipeline. We are not asking that venture-backed companies have exclusive access to these grants; we just want the opportunity to compete. We commend members of the House of Representatives for passing legislation last year which addresses this issue. We hope that the reauthorization of the SBIR program ultimately embraces this opportunity so together we will keep innovation flowing and continuously improve the quality of life for Americans.

Eliminating Regulatory Uncertainty

While venture capitalists are in the business of taking risk, we do indeed have risk thresholds that we cannot easily cross. If a company faces too many uncertainties on its road to success, often we will not make that investment, but seek other companies with a clearer pathway to success. In the last decade, unfortunately we have seen many instances where regulation has created additional burdens and uncertainties that threaten the funding of companies.

For example, many of our companies are struggling with the cost of Sarbanes-Oxley compliance which, while well-intentioned and necessary, has placed a disproportionate regulatory burden on

smaller entities that do not have the financial or human wherewithal to effectively comply, without giving up other endeavors. Venture capital funding that should be focused on research, or on sales and marketing, are today being directed towards accounting compliance. The Securities and Exchange Commission has put in place extensions for complying with this law, but has yet to permanently exempt these small cap companies. Our portfolio companies need certainty around this area of compliance so they can commit to a financial controls system that is appropriate and lasting, and instead begin channeling their funds towards growth.

In the life sciences sector, the regulatory uncertainty and lack of consistent leadership at the Food & Drug Administration has had a sustained adverse impact on the rate of new drug and device approval, and therefore on the new investment rate of venture capital firms into innovative companies in this sector. When the rules are not clear – and venture capitalists don't know whether a regulatory approval process will take three years and $15 million, or 10 years and $200 million – it is impossible to commit funds responsibly. We intend to continue to work with the FDA towards a certain and streamlined approval pathway for the most novel technologies and therapeutics.

Protecting Innovation

Venture-backed companies are in the business of improving the way we live and work. But for an innovation to be brought to market successfully and thrive there, that breakthrough must be protected from others that might infringe on the years of research and development work that preceded a market launch. There are two distinct areas that the government can support innovators in this way.

The first is the area of overall patent reform. Improving the quality of our patent system is critical to our country's innovation leadership. Many of our country's most promising innovative companies are also our most fragile. Therefore we support comprehensive patent reform that recognizes that defending against infringement is disproportionately burdensome for smaller companies. These companies do not have the resources to constantly defend their patents or fight with larger corporations who have the ability to infringe at a relatively low cost.

As Congress examines patent reform, we urge you to consider the challenges of these small companies and ensure that the law adequately protects them.

This protection could include a post-grant review process that is limited to 12 months so that small companies are not subject to the uncertainty and cost associated with endless challenges to their patents by large corporations. It also involves making sure that large infringers are subject to meaningful penalties that reflect the full value of the innovation in question. Such penalties are necessary deterrents for large companies that justify the cost of infringing because that cost is so low. The NVCA intends to be the voice for these small companies as patent reform is discussed this year, and we welcome the opportunity to work together with members of Congress toward reform.

The second area is more specific and involves companies that discover and develop novel biologic therapeutics for patients. Currently there is a debate as to when outside companies can enter this market and offer generic or similar alternatives, called follow-on biologics. I cannot stress the importance of protecting the innovative companies that have invested tens of millions of dollars and decades of development to bring these breakthroughs to market. If generic or quasi-generic alternatives enter the market shortly after the original biologic is made available, the biologic company will not be able to recoup its investment and these innovations will disappear as no investor will be able to fund them profitably. The result will be an elimination of an entire field of breakthrough medicine, and nobody will win. Patients and physicians will surely lose. We are currently advocating for sound protection of intellectual property in the area of follow-on biologics for a reasonable length of time in order to ensure ongoing incentives for innovation.

Reinvigorating a vibrant exit market.

The most immediate challenge that the recession has brought to the venture industry is the complete shutdown of the venture-backed IPO market. In 2008, there were just six venture-backed companies that went public on US exchanges. In a healthy year, this number should approach 150 offerings. To date in 2009, no venture-backed companies have gone public.

This situation is of deep concern from both a venture industry perspective and an economic one. From an industry perspective, many venture firms have mature companies that are ready to go public but will not do so under the current conditions. Consequently, some firms are forced to support these companies, both with dollars and time, much longer than originally planned. Because of this, they take their attention away from backing new innovative companies and returns are driven down. Economically, venture-backed companies that go public are significant creators of jobs. A separate Global Insight study revealed that more than 90 percent of the headcount growth at venture-backed companies takes place following an IPO. The current clog in the IPO pipeline, if it continues, will compel more companies to seek the acquisition exit route which, while respectable and profitable, does not result in the same level of economic value creation as an IPO does.

While the recession is to blame for the dramatic drought, there are also fundamental structural problems within our capital markets system that have made it difficult for small cap companies to go public. The cost imposed by Sarbanes-Oxley as well as the elimination of sell-side research resulting from the Global Settlement, better known as the Spitzer settlement, have changed the economics of going public in such a way that small cap companies are delaying or abandoning the IPO altogether. We believe that a full SEC review of the current regulations is in order, not to determine if the regulations are appropriate overall but to assess their impact on small companies and institute exemptions where appropriate. The one size fits all mentality of the last eight years needs to be re-examined and addressed for the sake of these smaller players. Precedent has shown that tiered compliance can be effectively applied and we would hope that there would be opportunities to do so in the coming year.

Conclusion

Over the years, the federal government and the venture capital industry have so often enjoyed a symbiotic relationship that has helped spur innovation and further our country's economic goals. Today, we face significant but not insurmountable challenges as we look towards economic recovery and job creation. The venture capital industry remains committed to investing in the

most promising, innovative small businesses our country has to offer. We do not need bailout money or additional money to invest – we simply need an environment that allows these companies to thrive. As Congress considers policies that impact small venture backed companies, we appreciate the opportunity to offer a voice that supports viability and growth for these entities. No other asset class supports the premise more that small businesses are the life blood of the US economy than venture capital. We are confident that you share our commitment to this sector and look forward to working with you as we move forward.

Thank you.